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Quest for Cash: Exempt Organizations, Joint Ventures, Taxable Subsidiaries, and Unrelated Business Income

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THE QUEST FOR CASH: EXEMPT ORGANIZATIONS, JOINT VENTURES, TAXABLE SUBSIDIARIES, AND UNRELATED BUSINESS INCOME

J. Patrick Plunkett and Heidi Neff Christianson[†]

I. BUSINESS ACTIVITIES PERFORMED DIRECTLY BY AN EXEMPT ORGANIZATION	3
A. <i>Unrelated Business Income Defined</i>	4
1. <i>Trade or Business</i>	5
2. <i>Regularly Carried On</i>	5
3. <i>Not Substantially Related</i>	8
B. <i>Substantiality Requirement: How Much Is Too Much?</i>	11
C. <i>Taxation of Unrelated Business Income</i>	16
II. BUSINESS ACTIVITIES PERFORMED THROUGH TAXABLE SUBSIDIARIES	17
A. <i>Establishing Parent and Subsidiary Relationship</i>	17
B. <i>Taxation of the Parent and Subsidiary</i>	21
III. PARTNERING WITH OTHERS	23
A. <i>Contractual Relationships</i>	23
1. <i>Royalties</i>	23
2. <i>Sponsorship Payments</i>	26
B. <i>Joint Ventures: Partnerships or LLCs Formed Jointly by Exempt Organizations with a For-Profit Partner(s)</i>	30
1. <i>Maintaining Tax-Exempt Status</i>	30

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a. <i>Exempt Purpose</i>	31
b. <i>Exempt Organization Control</i>	35
c. <i>Incidental Private Benefit</i>	46
2. <i>Taxation of Joint Ventures</i>	52
IV. CONCLUSION	54

This summer, the U.S. Senate Finance Committee held hearings regarding the need for enhanced governmental oversight of exempt organizations to deter abuses within tax-exempt organizations and to prevent third party misuse of exempt organizations.¹ The motives of exempt organizations are constantly the subject of scrutiny. This is never truer than when an exempt organization profits. Even so, out of necessity, exempt organizations have undertaken or established business or “for-profit”² activities. The task of defining how much business is “too much business” gives us the same trouble that pornography gave U.S. Supreme Court Justice Potter Stewart.³ We hesitate to specify what we understand to be embraced within the definition of “too much business,” but we know it when we see it.⁴

Most “for-profit” or “business” activities of exempt organizations take one of three forms:

(A) The exempt organization may undertake to perform the business activities within the existing structure of the exempt organization.

(B) The exempt organization may form a “taxable” subsidiary or affiliate which will perform the business activities.

(C) The exempt organization may “partner” with other individuals and entities (both nonprofit and for-profit) to form a corporation, limited liability company (LLC), partnership, joint venture, strategic alliance, or other collaborative effort which will perform the “for-profit” activities.

Depending in part upon which of these forms is chosen, any business activities by an exempt organization may result in: (i) income taxes being imposed upon the exempt organization or the

1. See I.R.S. News Release IR-2004-81 (June 22, 2004).

2. The term “for-profit” is somewhat of a misnomer because often the “for-profit” activities are housed in a taxable subsidiary corporation that is organized under applicable state law as a nonprofit or not-for-profit corporation.

3. See *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).

4. *Id.*

“for-profit” entity; (ii) the exempt organization losing its tax-exempt status; (iii) excise taxes being imposed by the Internal Revenue Service (IRS) on the individuals and for-profit companies (as well as on the managers of the exempt organization) with whom the tax-exempt organization conducts a business activity; (iv) a regulatory action brought against the organization by federal or state governmental authorities; or (v) all of the above. This article gives an overview of the regulations, Treasury rulings, IRS manuals, and case law that become important when an exempt organization decides to engage in business activity.

I. BUSINESS ACTIVITIES PERFORMED DIRECTLY BY AN EXEMPT ORGANIZATION

In order to qualify for tax-exempt status under § 501(a) of the Internal Revenue Code of 1986 (I.R.C.), an organization must be organized and operated exclusively for tax-exempt purposes.⁵ In general, an organization is treated as “organized” for an exempt purpose only if its charter or articles of incorporation limit the purposes of the organization to one or more exempt purposes, and do not expressly empower the organization to engage, other than as an insubstantial part of its activities, in activities that are not in furtherance of the exempt purposes.⁶ An organization will be treated as “operated” for an exempt purpose only if it engages primarily in activities that accomplish one or more exempt purposes.⁷ An organization will not be regarded as “operated” for an exempt purpose if more than an insubstantial part of its activities is not in furtherance of its exempt purposes.⁸ The regulations specifically recognize that an organization may qualify for tax-exempt status, even though it operates a trade or business,

5. I.R.C. § 501(a) exempts from federal income taxes (i) certain trusts formerly part of a stock bonus, pension or profit sharing plan described in I.R.C. § 401(a); (ii) certain religious or apostolic organizations described in I.R.C. § 501(d); and (iii) 28 types of organizations described in I.R.C. § 501(c)(1–28). Unless otherwise noted, this article applies only to organizations described in I.R.C. § 501(c)(3) which are “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes.” I.R.C. § 501(c)(3) Unless otherwise indicated, all citations in this article to the Internal Revenue Code (I.R.C.) refer to the Internal Revenue Code of 1986, as amended, codified at 26 U.S.C.A. (West 2004).

6. Treas. Reg. § 1.501(c)(3)-1(b) (as amended in 1990).

7. *Id.* § 1.501(c)(3)-1(c).

8. *Id.*

and even if the trade or business is substantial, *if* the trade or business is related to, or in furtherance of, the organization's exempt mission.⁹ The exempt organization should determine first whether income flowing from the activity is unrelated business income within the meaning of the Treasury Regulations, and second whether any unrelated business activity is substantial in light of all the other activities of the exempt organization. In general, a tax-exempt organization (other than a "private foundation" defined in I.R.C. § 509)¹⁰ may carry on a for-profit activity (which is known as "an unrelated trade or business" under I.R.C. § 513),¹¹ with two caveats. First, the organization's participation in an unrelated business must be limited so that the organization's exempt status is not jeopardized.¹² Second, the organization may be subject to the tax on the net income that it derives from the unrelated trade or business.

Tax on an exempt organization's unrelated trade or business taxable income is imposed at the regular corporate tax rate.¹³ All exempt organizations, other than certain instrumentalities of the federal government, are subject to the unrelated business income tax.¹⁴ The tax on unrelated trade or business was intended to level the playing field between exempt organizations that resemble for-profit organizations and tax-paying businesses.¹⁵

A. *Unrelated Business Income Defined*

The following three elements must exist before income generated by an exempt organization will be taxed as unrelated business income: (a) the activity must constitute a trade or business; (b) the trade or business must be regularly carried on by the exempt organization; and (c) the conduct of the trade or business must not be substantially related to the organization's exempt purpose (aside from the need of the organization for income or the use it makes of the profits derived).¹⁶

9. *Id.* § 1.501(c)(3)-1(e)(1) (as amended in 1990).

10. I.R.C. § 509(a).

11. *Id.* § 513(a).

12. Treas. Reg. § 1.501(c)(3)-1(e) (as amended in 1990).

13. I.R.C. § 511(a)(1).

14. *Id.* § 511(a)(2)(A).

15. Treas. Reg. § 1.513-1(b) (as amended in 1983); *see also* United States v. Am. Coll. of Physicians, 475 U.S. 834, 838 (1986).

16. Treas. Reg. § 1.513-1(a) (as amended in 1983); *see also* Rev. Rul. 2004-51, 2004-22 I.R.B. 974. The definition of unrelated business taxable income for social

1. *Trade or Business*

In general, any activity carried on for the production of income, which otherwise possesses the characteristics of a trade or business (the sale of goods or performance of service), constitutes a trade or business under the IRS definition.¹⁷ The activities do not “lose [their] identity as a trade or business merely because [they are] carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.”¹⁸ The Treasury Regulations provide as an example the regular sale of pharmaceutical supplies to the public by a hospital pharmacy.¹⁹ The sale of pharmaceuticals to the public does not lose its identity as a trade or business merely because the pharmacy also furnishes pharmaceutical supplies to the hospital and patients of the hospital in furtherance of its exempt purposes.²⁰ However, if the activity does not have the characteristics of a trade or business—as when the organization sends out low cost items in connection with the solicitation of charitable contributions—the activity is not a trade or business because the activity does not compete with taxable organizations.²¹

2. *Regularly Carried On*

To determine whether an activity is “regularly carried on,” the Treasury Regulations require consideration of the frequency and continuity with which the activities are conducted and the manner in which they are pursued.²² If activities are carried on in a manner generally similar to comparable commercial activities of

clubs described in I.R.C. § 501(c)(7) is different from the definition of unrelated business taxable income for other exempt organizations. *See* I.R.C. §§ 501(c)(7), 512 (a)(3)(A). For social clubs, unrelated business taxable income is the organization’s “gross income (excluding exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income.” *Id.* § 512(a)(3)(A). Social clubs must demonstrate a profit motive to deduct expenses from the activity claimed to be unrelated business taxable income. *Id.* *See also* *Portland Golf Club v. Comm’r*, 497 U.S. 154, 161 (1990).

17. Treas. Reg. § 1.513-1(b) (as amended in 1983).

18. I.R.C. § 513(c).

19. *Id.* § 513(e).

20. *Id.*

21. *Id.* § 513(a).

22. Treas. Reg. § 1.513-1(c)(1).

nonexempt organizations, they will ordinarily be deemed to be “regularly carried on.”²³ Where the conduct of a trade or business would normally be carried on all of the time, the conduct of such type of trade for “a few weeks” out of the year by an exempt organization would not be “regularly carried on.”²⁴ But the conduct of a year-round type of business activity, such as the operation of a parking lot, for one day per week, would constitute the regular carrying on of the business.²⁵

In determining whether business activities conducted intermittently by exempt organizations are “regularly carried on,” the IRS compares the manner and pursuit of the activity with that of taxable organizations.²⁶ If the exempt organization conducts the activity only intermittently, meaning discontinuously or periodically, and without the competitive and promotional efforts typical of taxable businesses, the activity would not be “regularly carried on.”²⁷ “For example, the publication of advertising in programs for sports events or music or drama performances will not ordinarily be deemed to be the regular carrying on of business.”²⁸ “Similarly, where an organization sells certain types of goods or services to a particular class of persons in pursuance of its exempt functions” (a university book store selling books to students, for example), casual sales unrelated to the mission of the exempt organization (selling a sweatshirt to a college visitor, for example) will not be treated as “regularly carried on.”²⁹ If the sales unrelated to the mission become systematic and consistently promoted and carried on, they will then meet the “regularly carried on” requirement.³⁰

The income derived from the conduct of an annual gala or similar fund raising event will not constitute a “regularly carried

23. *Id.*

24. Treas. Reg. § 1.513-1(c)(2)(i).

25. *Id.*

26. Treas. Reg. § 1.513-1(c)(2)(ii) (as amended in 1983).

27. *Id.*

28. *Id.*

29. *Id.* See also, Rev. Rul. 68-374, 1968-2 C.B. 242. An exempt hospital pharmacy existed to fill prescriptions for hospital patients but would occasionally fill prescriptions of non-hospital patients as a courtesy to its medical staff. *Id.* Because these sales were not promoted by the hospital, did not occur with frequency, and represented an insignificant part of the pharmacy’s total sales, the IRS concluded that the sales were not regularly carried on. *Id.*

30. Rev. Rul. 68-374, 1968-2 C.B. 242.

on” trade or business, even though it regularly recurs.³¹ An exempt organization that published a concert book in connection with its annual fundraising ball did not conduct a “regularly carried on” unrelated trade or business because the distribution of the book as a part of the annual fundraising ball brought the income within the regulation’s exception for intermittent activities.³² Income received from the sale of advertising in an annual yearbook (which was not an integral part of any annual fundraising event), however, was found to be a “regularly carried on” trade or business because the exempt organization contracted with a private firm to conduct an intensive advertising solicitation campaign covering a full calendar year for the yearbook.³³

Income from an intermittent unrelated business activity may be found to be “regularly carried on,” however, if the activity requires months of preparatory work integral to the activity itself. In a case that has not been acquiesced in by the IRS, the Tenth Circuit (reversing the decision of the tax court) held that the income received by the National Collegiate Athletic Association (NCAA) in connection with the sale of programs at the NCAA tournament was not unrelated business income because the sale of programs was not “regularly carried on” by the NCAA.³⁴ In that case, the Tenth Circuit held that the time spent soliciting advertisements and preparing them for publication was not relevant to the determination of whether an activity is “regularly carried on.”³⁵ The IRS disagreed, and has since provided that when the time spent in soliciting and selling advertising (what the Tenth Circuit characterized as preparatory time) was an integral part of the activity of advertising, it should be considered in determining whether an activity is “regularly carried on.”³⁶

31. Treas. Reg. § 1.513-1(c)(2)(iii) (as amended in 1983).

32. Rev. Rul. 75-201, 1975-1 C.B. 164 (distinguishing Rev. Rul. 73-424, 1973-2 C.B. 190).

33. Rev. Rul. 73-424, 1973-2 C.B. 190 (distinguished by Rev. Rul. 75-201, 1975-1 C.B. 164).

34. Nat’l Collegiate Athletic Ass’n v. Comm’r, 914 F.2d 1417, 1422-23 (10th Cir. 1990).

35. *Id.*

36. *Id.*, action on dec., 1991-015 (July 3, 1991). See also Tech. Adv. Mem. 97-21-001 (May 23, 1997) (where the IRS concluded that an unrelated business activity was regularly carried on where the exempt organization held a spring and a fall weekend-long concert event that required six months of preparatory time for each event).

3. *Not Substantially Related*

The third and most important element of an unrelated trade or business is whether the activity to be conducted is substantially related to the exempt purposes of the organization. The exempt organization and the trade or business is not substantially related just because the exempt organization requires income and the trade or business produces that income.³⁷ If the conduct of the trade or business is not substantially related to the exempt purposes of the organization, the trade or business is unrelated to the organization's exempt mission.³⁸ A trade or business is related to the exempt purposes, under the IRS's definition, only if the way in which the business or trade is conducted has a substantial causal relationship to the achievement of the exempt organization's exempt purposes.³⁹ For the trade or business to be substantially related to the exempt organization's purposes, "the production or distribution of the goods or the performance of the services . . . must *contribute importantly* to the accomplishment of those purposes."⁴⁰ Whether the production or distribution of goods or performance of services contributes importantly to the exempt purposes of an organization is determined on the facts and circumstances of each case.⁴¹ In determining whether an activity contributes importantly to the exempt function of the organization, the IRS considers the size and extent of the activity in relation to the nature and extent of the exempt function they purport to serve.⁴²

Business activities conducted on a larger scale than needed to support the exempt function of the organization will constitute unrelated trade or business.⁴³ For example, while the food sales of a restaurant owned by a museum to museum patrons and employees would not be unrelated business income (because having the food available for those people allows patrons to spend more time viewing the exhibits and enhances the efficient

37. Treas. Reg. § 1.513-1(d)(1) (as amended in 1983). An organization operated to carry on a trade or business shall not be exempt from taxation on the ground that all of its profits are payable to one or more tax-exempt organizations. I.R.C. § 502(a) (West 2002).

38. Treas. Reg. § 1.513-1(d)(2).

39. *Id.*

40. *Id.* (emphasis added).

41. *Id.*

42. *Id.* § 1.513-1(d)(3).

43. *Id.*

2004]

THE QUEST FOR CASH

9

operation of the museum),⁴⁴ sales of the same food to non-patrons would be unrelated business income because, in that respect, the activity was larger than necessary to support the exempt function of the organization.⁴⁵ The following rulings illustrate the IRS's application of the "contributes importantly" test.

1. The operation of a hospital gift shop patronized by patients, visitors making purchases for patients, and hospital employees does not constitute an unrelated trade or business because the shop improved the physical comfort and mental well being of its patients, thereby contributing importantly to its exempt purpose.⁴⁶
2. The operation of a furniture shop by an exempt halfway house to provide transitional employment for residents of the halfway house contributed importantly to the organization's exempt purposes by affording the residents gainful employment and enabling them to develop their ability to cope with emotional problems.⁴⁷
3. The sale and exchange of an exempt organization's mailing lists was unrelated business income where the list was so large that the exempt organization employed five staff persons to maintain the list, because the sale and rental of the list were made to for-profit businesses for purposes not substantially related to the organization's exempt purpose.⁴⁸
4. Sales of various items from a museum gift shop may or may not contribute importantly to the museum's exempt purposes. To determine if the sale of an item by a museum is related to its exempt purpose, the IRS considers the museum's primary purpose for selling

44. Rev. Rul. 74-399, 1974-2 C.B. 172.

45. Tech. Adv. Mem. 97-20-002, (May 16, 1997).

46. Rev. Rul. 69-267, 1969-1 C.B. 160.

47. Rev. Rul. 75-472, 1975-2 C.B. 208.

48. Tech. Adv. Mem. 95-02-009 (Jan. 13, 1995). Income received from the rental or exchange of mailing lists between organizations described in 501(c) and to which contributions are deductible under § 170(c)(2) or 170(c)(3) of the I.R.C. is not unrelated business income. I.R.C. § 513(h).

the item.⁴⁹ Where the primary purpose behind the sale of the item is utilitarian, ornamental, or only generally educational in nature, the sale of the item is not substantially related to the museum's exempt purposes. A number of factors, including the degree of connection between the item and the museum's collection, as well as the extent to which the item relates to the form and design of the original item, and the overall impression conveyed by the item are relevant to determining the relatedness of the sale to the museum's exempt purpose. If the exempt use or function predominates, the sale would be substantially related.⁵⁰

When an exempt organization's purpose is to benefit its members, a business activity must benefit the members of the group as a whole (e.g., the conduct of seminars and lobbying services),⁵¹ and must not provide specific services to members individually,⁵² to be substantially related to the organization's exempt purposes.

Special rules apply to the income from the sale of products made as a result of the organization engaging in its exempt function,⁵³ to the dual use of assets and facilities of exempt organizations,⁵⁴ and to the exploitation of goodwill or other intangible assets that were generated by the exempt organization in the carrying out of its mission.⁵⁵

49. Priv. Ltr. Rul. 2002-22-030 (March 4, 2002).

50. *Id.*

51. *Prof'l Ins. Agents v. Comm'r*, 726 F.2d 1097, 1104 (6th Cir. 1984).

52. *Nat'l Water Well Ass'n v. Comm'r*, 92 T.C. 75, 99 (T.C. 1989).

53. The sale by an exempt vocational school of weaving crafts made by its students was a related business within the meaning of § 513 of the Code, but the sale of crafts made by local residents (including former students of the school) made at home according to the school's specifications was an unrelated business. Rev. Rul. 68-581, 1968-2 C.B. 250.

54. Treas. Reg. § 1.513-1(d)(4)(iii) (as amended in 1983) gives the example of a museum that uses its theater as an ordinary motion picture theater for public entertainment in the evenings when the museum was closed. Because showing ordinary motion pictures does not contribute importantly to the exempt purposes of the museum, the income from such activity would be unrelated business income.

55. Treas. Reg. § 1.513-1(d)(4)(iv) gives the example of a scientific organization with an excellent reputation for biological research that exploits its reputation by endorsing laboratory equipment. The endorsements do not

2004]

THE QUEST FOR CASH

11

Excluded altogether from the definition of unrelated business income are activities: (1) carried on substantially by volunteers;⁵⁶ (2) carried on by an organization described in the Internal Revenue Code § 501(c)(3),⁵⁷ primarily for the convenience of its members;⁵⁸ and (3) involving the sale of donated property.⁵⁹

B. Substantiality Requirement: How Much Is Too Much?

If an exempt organization has unrelated business income, so long as the income is insubstantial, the only consequence to the exempt organization will be imposition of tax on the business income (less related expenses).⁶⁰ If the unrelated business activity becomes too substantial, the organization will be deemed not to be operating exclusively for exempt purposes and will not qualify for tax-exempt status.⁶¹

Exempt organizations generally seek an objective standard for determining whether an unrelated business activity becomes too substantial, such as a percentage of gross income, which clearly identifies when the organization has reached the substantiality threshold for unrelated business activity. Unfortunately, the I.R.C. and Treasury Regulations provide no bright-line guidance in this matter.

The IRS directs examiners to determine the relative size of unrelated business income activity as compared to the organization's total activities, and to consider:

1. The relationship of the business activity to the overall activities of the organization in terms of time, effort, and dollar income.

contribute importantly to the achievement of the organization's exempt status and the income from the endorsements is unrelated business income.

56. I.R.C. § 513(a)(1).

57. *Id.* § 513(a)(2). The exclusion also applies to colleges and universities described in § 511(a)(2)(B).

58. *Id.*

59. *Id.* § 513(a)(3). There are other exclusions as well. *See* I.R.C. §§ 513(d)(1), 513(g), 513(h)(1)(A), 513(h)(1)(B); Treas. Reg. §§ 1.513-3 (as amended in 1983), 1.513-5 (as amended in 1980), 1.513-6 (as amended in 1986).

60. *See* I.R.C. § 511(a). *See also* Orange County Agric. Soc'y, Inc., v. Comm'r., 893 F.2d 529, 533-34 (2d Cir. 1990).

61. Treas. Reg. § 1.501(c)(3)-1(c) (as amended in 1990); *Orange County*, 893 F.2d at 533-34.

2. The relationship between the business activity and the exempt function of the organization.
3. The reason that the organization conducts the particular business activity.
4. The methods of operation and the control exercised by the board of directors or trustees over the business operations.⁶²

Treasury rulings, Technical Advice Memoranda (TAM), and a small body of case law provide some guidance. In a 1964 Treasury ruling, the IRS stated that to meet the operational test as an organization described in § 501(c)(3), an exempt organization must carry on a charitable program “commensurate in scope with its financial resources.”⁶³ In a 1995 TAM, the IRS considered a variety of unrelated business activities being conducted by an exempt organization.⁶⁴ The IRS suggested that in determining whether an unrelated business is substantial, it would take into consideration the time expended by the organization’s employees on exempt versus nonexempt activities, as well as revenues derived from and functional expenses incurred for the exempt versus nonexempt activities.⁶⁵ Considering the employee time (which was not quantified in aggregate), the revenue from the nonexempt activities (which the TAM concluded constituted approximately twenty-three percent of the organization’s total revenue), and the functional expenses attributable to the nonexempt activities (which amounted to 19.7% of the organization’s total functional expenses), the IRS concluded that the organization’s nonexempt activities did not warrant revocation of its tax-exempt status.⁶⁶

In another TAM, the IRS considered the operations of an exempt internet service provider.⁶⁷ The internet service provider made its service available under a sliding-scale rate system to the public, businesses, and charities.⁶⁸ Low-income individuals,

62. INTERNAL REVENUE SERVICE, EXEMPT ORGANIZATIONS EXAMINATION GUIDELINES HANDBOOK, 17 § 7.8.1.1.7 *Unrelated Business Income* (1999).

63. Rev. Rul. 64-182, 1964-1 C.B. 186.

64. Tech. Adv. Mem. 95-50-001 (Dec. 15, 1995).

65. *Id.*

66. *Id.*

67. Tech. Adv. Mem. 2002-03-069 (Jan. 18, 2002).

68. *Id.*

disadvantaged businesses, schools, and libraries were charged less than the general public.⁶⁹ As it evolved, the internet service provider began receiving increasing amounts of its income from user fees that did not come from low-income individuals or charitable institutions. Between 1995 and 1997, over seventy-five percent of its income came from user fees from non-disadvantaged entities.⁷⁰ The IRS concluded that under these particular facts, the organization's tax-exempt status should be revoked.⁷¹ Interestingly, the IRS also said that "[g]enerally, courts have denied exemption to organizations that conducted nonexempt activities which generated income in excess of approximately twenty-five percent of the organization's total annual income."⁷²

In 1994, the Fifth Circuit upheld a tax court decision denying the tax-exempt status of an organization that claimed to provide social services for the poor and disadvantaged.⁷³ By its own estimates, the organization committed forty-five percent of its "time expended" on activities the tax court found to be unrelated to the charitable purposes for which the organization sought tax-exempt status.⁷⁴ Without any discussion of income or expenses, the Fifth Circuit concluded that activities comprising forty-five percent of an organization's time are not insubstantial.⁷⁵

A 1977 tax court case involved an exempt trade association (as described in § 501(c)(6) of the 1954 Internal Revenue Code) that maintained an insurance program for its members.⁷⁶ The IRS revoked the Association's exempt status because it found that it engaged in more than insubstantial nonexempt purposes, including the administration of the insurance program.⁷⁷ The Association argued that because it spent an insubstantial amount of its employee time (fifteen percent) administering the insurance program, the unrelated trade or business did not meet the substantiality requirement.⁷⁸ The IRS argued that the relevant measure was the taxpayer's financial data, such as its statements of

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

73. *Nationalist Movement v. Comm'r*, 37 F.3d 216 (5th Cir. 1994).

74. *Id.* at 220–21.

75. *Id.*

76. *Associated Master Barbers & Beauticians of Am., Inc. v. Comm'r*, 69 T.C. 53 (1977).

77. *Id.* at 55, 64–66.

78. *Id.* at 67–68.

receipts and disbursements.⁷⁹ During the years at issue, the Association's receipts from the insurance program totaled between eleven and forty-three percent of its total receipts and disbursements from the insurance program totaled between twenty-one and thirty-five percent of total disbursements.⁸⁰ The tax court said that both time and financial data should be considered in determining the extent of an organization's unrelated business activities.⁸¹ The tax court noted that, with respect to the insurance program, the Association's staff was required to keep voluminous records and to make many entries on each record to process claims and maintain the policies.⁸² The tax court found that the evidence of the voluminous records and clerical duties required, as well as the persuasive financial data, was sufficient to establish that the unrelated business activities were not insubstantial.⁸³

A 1990 decision by the Second Circuit examined the tax-exempt status of an organization incorporated "to promote the interests of agriculture and horticulture in Orange County, New York."⁸⁴ Its activities included "exhibiting and judging of animals, farm and garden products, arts, [and] crafts."⁸⁵ The organization owned the state fairgrounds.⁸⁶ Situated on the fairgrounds was a speedway used traditionally for automobile races.⁸⁷ In addition to holding races during the state fair, the organization operated more than twenty races during the year that did not have any relation to the state fair.⁸⁸ The court found that the unrelated races were an unrelated trade or business which generated income of between 29.2 and 34.7% of the organization's total revenues for three consecutive years.⁸⁹ The court concluded that this amount of unrelated income was a substantial nonexempt purpose and

79. *Id.* at 68.

80. *Id.*

81. *Id.*

82. *Id.* at 69.

83. *Id.* at 68–69. Internal Revenue Code § 501(m)(1) provides that organizations described in §§ 501(c)(3) and 501(c)(4) may not provide commercial-type insurance as a substantial part of their activities.

84. *Orange County Agric. Soc'y, Inc. v. Comm'r*, 893 F.2d 529, 530 (2d Cir. 1990).

85. *Id.* at 530–31.

86. *Id.* at 531.

87. *Id.*

88. *Id.*

89. *Id.*

revoked the organization's exempt status.⁹⁰

In a 1984 case out of the Seventh Circuit, the tax court below had concluded that an exempt organization, a Mennonite Church, had a substantial unrelated business activity when twenty-two percent of the church's funds were set aside in a "medical aid plan" to reimburse individual church members for expenses incurred for health care, hospitalization, surgery, and death.⁹¹ The Seventh Circuit did not address the tax court's holding that the medical aid plan was a substantial unrelated business expense because it found that running the medical aid plan *was* substantially related to the Mennonite's religious beliefs, which included the pooling of resources for mutual benefit regardless of individual income.⁹² Because the medical aid plan contributed importantly to the exempt purposes of the church, its operation was not an unrelated trade or business in the first place.⁹³

To reduce the likelihood that the IRS will find an activity carried on by an exempt organization to be an unrelated trade or business, an exempt organization can take the following steps. First, the purpose clauses of the Articles of Incorporation (or charter) of the exempt organization should be drafted to encompass activity that contributes importantly to the organization's exempt purposes, but which otherwise might be considered unrelated trade or business activity. Articles of Incorporation of existing exempt organizations may usually be amended to broaden what were originally narrowly worded purpose clauses. Second, the exempt organization's application for exemption (IRS Form 1023 or 1024), should include a description of the organization's related business activities. Finally, the exempt organization should take particular care every year, when completing Part III of IRS Form 990, to include and describe its related trade or business activity as part of the exempt organization's program service accomplishments.

90. *Id.* at 533–34. The court also found alternative grounds for revoking the organization's tax-exempt status of private inurement. *Id.* at 534.

91. *Bethel Conservative Mennonite Church v. Comm'r*, 746 F.2d 388, 389–90 (7th Cir. 1984).

92. *Id.* at 391–92.

93. *Id.*

C. *Taxation of Unrelated Business Income*

When an exempt organization conducts an unrelated trade or business activity, it pays tax at the regular corporate rate on the income from the activity.⁹⁴ Exempt organizations must answer question 78a of Part VI of IRS Form 990 asking whether the organization had unrelated business gross income of \$1,000 or more during the year. If it did, the tax is reported on IRS Form 990-T, which the exempt organization files in addition to IRS Form 990. Only the net income⁹⁵ derived from conducting the unrelated trade or business is taxable.⁹⁶ As a result, it is important to charge against the unrelated trade or business income any expenses that are properly related to the production of that income. If assets or personnel are used to carry on both exempt and nonexempt activities within an exempt organization, the expenses of the assets or personnel must be allocated between the exempt and the nonexempt uses on a reasonable basis.⁹⁷ Obviously, to the extent that shared or dual expenses can properly be allocated to an organization's taxable (nonexempt) rather than its nontaxable (exempt) activities, the organization's taxable income (and therefore its taxes) will be reduced.⁹⁸

Even though a tax-exempt organization receives income from an unrelated trade or business, the organization need not pay taxes on certain specific types of passive income.⁹⁹ Passive income excluded from the unrelated trade or business tax includes: dividends, interest, annuities, royalties, rents from real property, and gains from the sale, exchange, or other disposition of a capital

94. Treas. Reg. § 1.511-1 (as amended in 1971).

95. Defined as gross income less any allowable deductions that are directly connected with the carrying on of the unrelated trade or business by Treasury Regulation § 1.512(a)-1(a) (as amended in 2002).

96. Treas. Reg. § 1.512(a)-1.

97. *Id.* § 1.512(a)-1(c).

98. There is the risk, however, that allocating expenses to the nonexempt activity (instead of to the exempt activity) may result in a determination that an unrelated trade or business activity is not insubstantial. See discussion, *supra* Part I.A(2) (regarding the manner in which the IRS and courts determine whether an unrelated business activity is too substantial for the exempt organization to maintain its tax-exempt status).

99. I.R.C. § 512(b) (1), (2), (3), (5), (7), (8), (9), (15), (16).

asset.¹⁰⁰ These items will be taxable, however, to the extent that they are received from property that is “debt-financed” and the use of which is not substantially related (aside from the organization’s need for income or funds) to the organization’s exercise or performance of its exempt functions.¹⁰¹

II. BUSINESS ACTIVITIES PERFORMED THROUGH TAXABLE SUBSIDIARIES

There are many reasons an exempt organization may want to move part of its activities into a taxable subsidiary. An exempt organization may want to immunize itself from a high-risk activity or to allow different executives to participate in specific functions to promote accountability of those specific functions. In many cases, there may be activities that an exempt organization cannot directly undertake, that can be accomplished by a subsidiary. For example, a scientific or research organization may want to form a subsidiary to retain its patents because Treasury Regulations provide that an organization will not meet the requirements of I.R.C. § 501(c)(3) if it retains the ownership or control of more than an insubstantial portion of the patents, copyrights, processes or formulae resulting from the research.¹⁰² For purposes of this article, it is assumed that the primary motivation of an exempt organization in forming a taxable subsidiary or affiliate is to prevent the unrelated business income of the organization from becoming a substantial activity of the exempt organization, thereby jeopardizing its tax-exempt status.¹⁰³

A. *Establishing Parent and Subsidiary Relationship*

Logistically, an exempt organization may form a taxable subsidiary simply by filing Articles of Incorporation, with the office of the relevant state’s Secretary of State or comparable government authority, which identify the exempt organization as the sole member or shareholder of the new corporation.¹⁰⁴ The taxable

100. *Id.*

101. I.R.C. § 514. They are also taxable to the extent they are received from a related organization, as discussed in Part II.B of this article.

102. Treas. Reg. § 1.501(c)(3)-1(d)(5)(iv)(b) (as amended in 1990).

103. See discussion of substantiality of unrelated business, *supra* Section I.A.

104. In some states, such as Minnesota, a nonprofit corporation may issue stock. See MINN. STAT. § 317A.403 (2002) (a nonprofit corporation may issue preferred or common stock in lieu of membership certificates). State laws vary on

subsidiary can be either a nonprofit or for-profit corporation. An LLC should not be used, however, because it would not be afforded separate tax status.¹⁰⁵

For the corporate separateness of the organizations to be recognized by the IRS, the subsidiary must not be a mere arm or instrumentality of the parent.¹⁰⁶ Where a corporation is organized with a true intention that it will have some real and substantial business function, its existence will not generally be disregarded for tax purposes.¹⁰⁷ In cases where a parent exempt organization owns all the stock of a taxable subsidiary, the IRS has concluded that the parent's ownership of the stock of the subsidiary is a proper investment, rather than an activity that could be an unrelated business activity.¹⁰⁸

The IRS has provided the following guidance for establishing the required "separateness" between an exempt parent organization and its wholly-owned taxable subsidiary. In Private Letter Ruling 95-42-045, an exempt organization formed a taxable subsidiary which the IRS determined to be legitimately separate from the parent.¹⁰⁹ For an interim period of time (no longer than six months from the transfer of assets from the parent to the subsidiary), the officers of the parent were also the officers of the subsidiary.¹¹⁰ A majority of the board members of the subsidiary were independent of the parent's board of directors.¹¹¹ The secretary and treasurer of the subsidiary were officers of the parent, but the CEO and President of the subsidiary were independent of the parent's board of directors.¹¹² There was no understanding or agreement that the parent would direct or actively participate in the day-to-day management of the subsidiary. To the extent that

this point.

105. See Treas. Reg. § 301.7701-3(b) (as amended in 2004).

106. *Moline Props., Inc. v. Comm'r*, 319 U.S. 436, 438-39 (1943) (concluding that a corporate entity can remain separate as long as its "purpose is the equivalent of business activity"); *Krivo Indus. Supply Co. v. Nat'l Distillers and Chem. Corp.*, 483 F.2d 1098, 1106 (5th Cir. 1973) (comparing cases that discussed the "instrumentality rule").

107. *Britt v. United States*, 431 F.2d 227, 234 (5th Cir. 1970); Priv. Ltr. Rul. 95-42-045 (July 28, 1995).

108. Priv. Ltr. Rul. 2004-25-050 (Mar. 24, 2004); Priv. Ltr. Rul. 96-04-019 (Oct. 30, 1995).

109. Priv. Ltr. Rul. 95-42-045 (July 28, 1995).

110. *Id.*

111. *Id.*

112. *Id.*

the subsidiary leased space from the parent and used the parent's office equipment and staff, the corporations executed a written services agreement between them governing the provision of the space, equipment, and services.¹¹³ The corporations kept detailed records reflecting actual usage of the space, equipment and services.¹¹⁴ The subsidiary reimbursed the parent appropriately for all space, equipment and services received from the parent.¹¹⁵ Based on these facts, the IRS concluded that the activities of the subsidiary should not be attributed to the parent, and their corporate separateness should be respected.¹¹⁶

Similarly, in General Counsel Memorandum (GCM) 39,326, an exempt organization formed several taxable subsidiaries, all for bona fide business purposes.¹¹⁷ For each subsidiary, the parent exempt organization was the sole shareholder, and appointed the boards of directors of the subsidiaries.¹¹⁸ A majority of the board members of the subsidiaries were not on the board of directors of the parent.¹¹⁹ Although the CEO of the parent could serve as the board chair of the subsidiaries, the CEO of each subsidiary was neither a board member nor an officer of the parent.¹²⁰ The parent did not participate in the management of the taxable subsidiaries or in their day-to-day operations.¹²¹ All of the taxable subsidiaries distributed their earnings in excess of reasonable operating capital and other reserves to the parent exempt organization.¹²² The GCM concluded that this structure was sufficient to insure that any subsidiary was not a "mere arm, agent, or instrumentality" of the parent.¹²³

When an exempt organization forms a taxable subsidiary for the purpose of reducing the risk that unrelated trade or business activity will jeopardize its tax-exempt status, the organization may want to consider the following:

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

117. Gen. Couns. Mem. 39,326 (Jan. 17, 1985).

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

1. The taxable subsidiary should have its own tax identification number and file separate tax returns from the exempt parent.
2. The chairperson and executive director of the parent-exempt organization may serve as incorporators of the taxable subsidiary.
3. The exempt parent can serve as the sole member or shareholder of the taxable subsidiary, allowing it to retain significant control over the subsidiary.
4. The board (or president) of the exempt parent organization can appoint one or more persons to serve on the board of the subsidiary, allowing a majority of the board members of the subsidiary to be independent of the exempt parent's board of directors. Board meetings of the subsidiary may be held immediately following board meetings of the parent for the convenience of the overlapping directors, but minutes should be kept separately.
5. Officers may overlap between the parent and subsidiary so long as the persons serving as officers of both corporations understand and maintain clear distinctions between their service to the parent and their service to the subsidiary. The bylaws of the subsidiary may provide that the President or CEO of the parent is also the President or CEO of the subsidiary. However, in such a case, actual day-to-day operations of the subsidiary should be placed in the hands of a different officer (e.g. a Chief Operating Officer) or equivalent position for the subsidiary.
6. Capitalization of the subsidiary can be accomplished by identifying and valuing the assets to be transferred to the subsidiary from the parent. The assets should be set forth in a schedule. At the initial meeting of the incorporators (or the board of directors) of the subsidiary, the incorporators (or directors) elect to issue to the parent the sole membership, or all of the

stock, in the subsidiary in exchange for the scheduled assets. The exempt parent's balance sheet is reduced by the assets transferred to the subsidiary, and those assets are replaced with an asset item being the membership or stock in the subsidiary. The exempt organization must make certain that assets transferred to the subsidiary have not been restricted by a donor for a particular exempt use. The assets should be transferred between the parent and subsidiary pursuant to a written asset transfer agreement.

7. While it is permissible for the parent and taxable subsidiary to share space, equipment, and staff, they must do so pursuant to a written agreement whereby the subsidiary pays fair market value to the parent for all space, equipment, and staff time actually used by the subsidiary. The parent may in no manner subsidize the subsidiary.
8. The internal controls of the subsidiary will be a key to demonstrating that the subsidiary is not a mere arm or instrumentality of the parent. The subsidiary must keep accurate and separate records from the parent. The subsidiary and parent should not share bank accounts. Outside accountants should review the subsidiary's records and should prepare annual financial statements. The subsidiary's corporate record book should be kept current. Proper authorization for all actions requiring formal corporate action and of account signatories should be carefully documented in the board minutes.

B. Taxation of the Parent and Subsidiary

The establishment of a separate for-profit subsidiary does not avoid taxation of the business activity. Rather, the creation of the for-profit subsidiary shifts the obligation to pay the tax from the exempt organization (which reports unrelated trade or business income on IRS Form 990-T) to the subsidiary or affiliate (which reports its income on IRS Form 1120, U.S. Corporation Income Tax Return).

Amounts paid as dividends from the taxable subsidiary to the

exempt parent organization are not taxable to the parent exempt organization.¹²⁴ Although amounts received by a tax-exempt organization as interest, annuities, rents, or royalties are not usually subject to unrelated business income tax, a parent *with at least fifty percent control*¹²⁵ of a subsidiary must include a portion of the interest, annuities, royalties, and rents derived from the controlled subsidiary as an item of gross income in computing unrelated business taxable income.¹²⁶ An exempt organization parent controlling at least fifty percent of a subsidiary must include in its unrelated business taxable income, the interest, annuities, royalties, and rents received from the subsidiary to the extent that the payment reduces the net unrelated income (or increases the net unrelated loss) of the subsidiary.¹²⁷ For a nonexempt (taxable) subsidiary, net unrelated income is equal to that portion of the subsidiary's taxable income that would be unrelated business taxable income if the entity were an exempt organization and had the same exempt purposes as the parent.¹²⁸

124. I.R.C. § 512(b)(1).

125. "Control" is defined as ownership by vote or value of more than fifty percent of the stock in the corporation, or in the case of a partnership, more than fifty percent of the profits interests or capital interests in the partnership. *Id.* § 512(b)(13)(D)(i). Part III of Schedule A of IRS Form 990 also requires disclosure and a detailed explanation of transactions between an exempt organization and any taxable organization with which the exempt organization is affiliated.

126. I.R.C. § 512(b)(13). For taxable years beginning before August 4, 1997, if the parent owned at least eighty percent of the total voting power of all classes of stock of the subsidiary entitled to vote, and at least eighty percent of the total number of shares of all other classes of stock, the control test was met. Congress broadened the scope of control in the Taxpayer Relief Act of 1997 in order to prevent circumvention of the control test through the use of second-tier subsidiaries and other corporate structures. *See* General Explanation of the Taxpayer Relief Act of 1997 (JCS-23-97) (Dec. 17, 1997); H.R. Rep. No. 220, 105th Cong., 1st Sess., 561-62 (1997).

127. I.R.C. § 512(b)(13)(A). Question 88 of Part VI of IRS Form 990 requires the parent tax-exempt organization to state whether it owned a fifty percent or greater interest in a taxable corporation or partnership, or an entity disregarded as separate from the organization under the Treasury Regulations. Part IX of IRS Form 990 requires any exempt organization that owned a fifty percent or greater interest in any of those entities to describe and explain the relationship between the parent exempt organization and the controlled subsidiary, partnership or disregarded entity.

128. I.R.C. § 512(b)(13)(B)(i)(I).

III. PARTNERING WITH OTHERS

An exempt organization may find that otherwise unavailable capital might be available to the organization if it forms a joint venture with a “for-profit” partner. This relationship might take the form of (1) a contractual relationship; or (2) a for-profit partnership or limited liability corporation taxed as a partnership.

A. *Contractual Relationships*

Two of the more common types of contractual relationships entered into by exempt organizations with for-profit partners include royalty agreements and sponsorship payments. Both present an opportunity for revenue to the exempt organization and the potential for unrelated business income, taxable to the exempt organization if the relationship is not structured properly.

1. *Royalties*

Exempt organizations and for-profit partners may mutually benefit when the exempt organization endorses the products or services of the for-profit business. These agreements have typically been referred to as “affinity agreements,” and include everything from car rental discounts to communication packages, internet access, vending machine displays, and credit card offers. The basic premise behind affinity agreements is that an exempt organization receives a royalty for allowing a business to use its name or other intangible asset to promote a product or a service.¹²⁹

So long as the payment meets the definition of a royalty, the payment to the exempt organization is not unrelated business taxable income.¹³⁰ A royalty is defined as a payment for the use of a

129. See *Sierra Club, Inc. v. Comm’r*, 86 F.3d 1526, 1528 n.2 (9th Cir. 1996) (“An affinity . . . program is an arrangement by which an organization . . . agrees that a credit card issuer may use the organization’s name and logo to market an affinity credit card . . . in exchange for a small percentage of total amounts charged on the affinity card.”).

130. I.R.C. § 512(b)(2); Treas. Reg. § 1.512(b)-1(b) (2000). But note that royalties attributable to debt-financed property are included in unrelated business income, I.R.C. § 512(b)(4), and that royalties derived from a controlled entity are included in unrelated business income, I.R.C. § 512(b)(13).

valuable, intangible property right.¹³¹ Payments for the use of an exempt organization's name, trademarks, trade names, service marks, or copyrights, as well as for the use of the name, photograph, likeness, or facsimile signature of a member of an exempt organization, are ordinarily classified as royalties.¹³² A royalty payment cannot include payments for services rendered, so where an exempt organization is actively involved in the development and management of the activities surrounding the royalty agreement or has considerable control of those activities, the payment is unlikely to be characterized as a royalty.¹³³ The fact that the exempt organization retains the right to approve the quality or style of the products and services it endorses through the royalty agreement does not cause payments to the exempt organization under the royalty agreements to lose their characterization as royalties.¹³⁴ In the context of royalty agreements between exempt organizations and a for-profit business the use of the valuable, intangible right must benefit the for-profit business and not the exempt organization to qualify as a royalty.¹³⁵

The following examples illustrate the definition of royalty payments between exempt organizations and for-profit businesses.

1. An exempt alumni association raised money for its school by agreeing to let a bank offer credit cards using the name of the association.¹³⁶ Under the agreement, the alumni association was required to provide the bank with accurate mailing lists and materials that could be reproduced and distributed to the association's members (after approval of the materials by the association) at least once per year.¹³⁷ The bank paid the association a percentage of what the

131. See *Disabled Am. Veterans v. Comm'r*, 94 T.C. 60, 70 (1990), *rev'd on other grounds*, 942 F.2d 309 (6th Cir. 1991).

132. Rev. Rul. 81-178, 1981-2 C.B. 135.

133. *Disabled Am. Veterans v. United States*, 650 F.2d 1178, 1185-89 (Ct. Cl. 1981), *aff'g, rev'g, & rem'g* 80-2 USTC 9568 (Ct. Cl. 1980); see also, Rev. Rul. 81-178, 1981-2 C.B. 135.

134. Rev. Rul. 81-178, 1981-2 C.B. 135 (citing *Lemp Brewing Co. v. Comm'r*, 18 T.C. 586 (1952), *acq.*, 1952-2 C.B. 2, and citing Rev. Rul. 76-297, 1976-2 C.B. 178).

135. *Ark. State Police Ass'n v. Comm'r*, 282 F.3d 556, 559 (8th Cir. 2002).

136. *Or. State Univ. Alumni Ass'n v. Comm'r*, 193 F.3d 1098, 1099 (9th Cir. 1999).

137. *Id.*

association's members charged on their credit cards plus a nominal amount for each new member and each annual renewal.¹³⁸ The small effort the association expended (allowing the bank to use the association's goodwill, including its name and membership list) did not convert the royalty agreement into a service agreement and was not unrelated business income taxable to the association.¹³⁹

2. An exempt organization of professional athletes licensed its trademark and other intangible assets to for-profit businesses to use to sell products.¹⁴⁰ The agreement between the exempt organization and the businesses also provided that members of the exempt organization would make appearances to endorse the for-profit business's products.¹⁴¹ The payments to the exempt organization for the use of the trademark were royalties, and thus not subject to unrelated business income tax; but the payments to the exempt organization for appearances by the exempt organization's members were not royalties.¹⁴²
3. An exempt labor organization contracted with a for-profit publishing company to publish a magazine sent to the labor organization's members three times each year.¹⁴³ The agreement between the exempt

138. *Id.*

139. *Id.* at 1101-02. The Ninth Circuit distinguished *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996), where a similar agreement was found not to constitute a royalty agreement on the grounds that the Sierra Club agreed to cooperate with the for-profit business on a continuing basis in the solicitation and encouragement of the club's members to utilize the services provided by the for-profit business. On remand from the Ninth Circuit, the tax court concluded that the Sierra Club's agreement to provide continuing cooperation in the solicitation and encouragement of its members to use the credit card did not extend beyond the endorsement that necessarily results from the licensing of a name, logo, or other intangible rights. *Sierra Club, Inc. v. Comm'r*, 77 T.C.M. (CCH) 1569 (1999). Thus, the tax court concluded that none of the income received by the Sierra Club as a result of the affinity credit card program was unrelated business income taxable to the Sierra Club. *Id.*

140. Rev. Rul. 81-178, 1981-2 C.B. 135.

141. *Id.*

142. *Id.*

143. *Ark. State Police Ass'n v. Comm'r*, 282 F.3d 556, 557 (8th Cir. 2002).

organization and the publishing company was titled a royalty agreement. The duties of the exempt organization's vice president for public relations included developing content for the magazine.¹⁴⁴ Because the agreement provided for the use of the labor organization's name *to benefit the exempt organization and not the for-profit publisher*, the proceeds to the exempt organization from the agreement could not constitute a royalty, even if the exempt organization spent very little time working on the magazine.¹⁴⁵

To avoid having an endorsement agreement (the revenue from which would not be taxed as unrelated business income) characterized as an agreement to provide services (the revenue from which would be taxable as unrelated business income), an exempt organization should: (a) call the agreement a royalty agreement, and not use the words "agency" or "agent"; (b) avoid the use of the terms "joint venture" or "partnership" in the agreement; (c) base the fees in the agreement on gross revenue instead of net profits; and (d) draw up separate agreements outlining any service the exempt organization is required to render to the for-profit business (rather than including such language in the endorsement agreement).

2. Sponsorship Payments

The issue of sponsorship payments first appeared in 1991 when the IRS concluded that payments to an exempt organization holding a college football game from its corporate sponsor were unrelated business income because the exempt organization provided advertising services to the corporate sponsor in connection with the game.¹⁴⁶ Exempt organizations protested this position of the IRS, and the result was the issuance of final

144. *Id.* at 558. The Eighth Circuit relied on *National Collegiate Athletic Ass'n v. Commissioner*, 92 T.C. 456 (1989), *rev'd on other grounds*, 914 F.2d 1417 (10th Cir. 1990). In that case the NCAA contracted with a publisher to solicit advertisements for inclusion in the NCAA's tournament program. *NCAA v. Comm'r*, 92 T.C. at 458. The tax court concluded the publisher was acting on behalf of the NCAA to promote the NCAA, rather than the NCAA allowing the use of its name to promote the publisher's business or service. *Id.* at 469–70.

145. *Ark. State Police Ass'n*, 282 F.3d at 559.

146. Tech. Adv. Mem. 91-47-007 (Nov. 22, 1991).

regulations in 2002 governing treatment of payments from corporate sponsors to exempt organizations and providing guidance as to when those payments represent unrelated business taxable income to the exempt organization.¹⁴⁷

Sponsorship payments to an exempt organization do not constitute unrelated business income taxable to the exempt organization if the sponsor does not receive any substantial return benefit.¹⁴⁸ A “substantial return benefit” is any benefit in connection with the activity of the exempt organization, other than (1) the use or acknowledgment of the sponsor, or (2) insubstantial benefits, the aggregate fair market value of which do not exceed two percent of the amount of the sponsorship payment.¹⁴⁹

“Use or acknowledgment” of the sponsor that would not result in unrelated business income taxable to the exempt organization includes: (1) granting exclusive sponsorship in an activity or collection of activities to a for-profit business;¹⁵⁰ (2) the use of “logos and slogans that do not contain qualitative or comparative descriptions of the sponsor’s products, services, facilities or company”; (3) the use of “a list of the sponsor’s locations, telephone numbers, or Internet addresses”; (4) the use of “value-neutral descriptions, including displays or visual depictions, of the sponsor’s product-line or services”; and (5) the use of “the sponsor’s brand or trade names and product or service listings.”¹⁵¹

On the other hand, if an exempt organization “advertises” for the sponsor in connection with the activity, the sponsorship payment becomes unrelated business income taxable to the exempt organization.¹⁵² Advertising means any message or other

147. Treas. Reg. § 1.513-4 (2002).

148. *Id.* § 1.513-4(c). Excluded from the sponsorship exception to unrelated trade or business are payments made in connection with a qualified convention and trade show activity, § 1.513-3(b) (1983)), and the sale of advertising or acknowledgments in an exempt organization’s regularly published periodicals, § 1.512(a)-1(f) (as amended in 2002).

149. Treas. Reg. § 1.513-4(c)(2). It is irrelevant whether the sponsored activity is related or unrelated to the exempt organization’s exempt purposes. It is also irrelevant whether the sponsored activity is, or is not, regularly carried on by the exempt organization. § 1.513-4(c).

150. But, if there is an exclusive sponsorship agreement and the arrangement limits the sale, distribution, availability, or use of goods, services or facilities that compete with the sponsor’s goods, services, or facilities, the sponsor has received a substantial return benefit, and the payment to the exempt organization becomes unrelated business income. § 1.513-4(c)(2)(vi)(B).

151. Treas. Reg. § 1.513-4(c)(2)(iv).

152. *Id.* § 1.513-4(c)(2)(v).

programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product. Advertising includes messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service facility or product. A single message that contains both advertising and an acknowledgment is considered advertising.¹⁵³

The following three examples illustrate the definition of sponsorship payments between exempt organizations and for-profit businesses.

1. An exempt organization organizes a walkathon. A for-profit business sponsors the walkathon by providing free drinks, refreshments and prizes for participants. The exempt organization adds the sponsor's name to the title of the walkathon, lists the sponsor's name in promotional fliers and other advertising for the event, and on T-shirts worn by participants. The value of the prizes and refreshments are not unrelated business income to the exempt organization because they qualify as sponsorship payments without any substantial return benefit.¹⁵⁴
2. An exempt agricultural membership organization has arrangements with certain businesses to provide special or discounted services or products to the organization's members.¹⁵⁵ Some of the businesses that provide member benefits also sponsor activities at the conventions or similar events held by the exempt membership organization.¹⁵⁶ The organization acknowledges these business sponsors on its website and includes as part of its sponsor acknowledgments links to the sponsors' websites.¹⁵⁷ The provision of the link from the exempt organization's website to the

153. *Id.*

154. *See* Treas. Reg. § 1.513-4(f) (2002).

155. Priv. Ltr. Rul. 2003-03-062 (Oct. 22, 2002).

156. *Id.*

157. *Id.*

sponsors' websites is an acknowledgment and will not constitute unrelated business income taxable to the exempt organization.¹⁵⁸

3. An exempt organization sponsors a year-long educational campaign to educate the public about a particular medical condition.¹⁵⁹ A pharmaceutical company that manufactures a drug used to treat the condition provides funding for the campaign.¹⁶⁰ The exempt organization's website has a link to the pharmaceutical company's website, where the pharmaceutical company states that the exempt organization endorses the use of the drug, and suggests that people request a prescription for the drug.¹⁶¹ The exempt organization reviewed and approved the statement on the pharmaceutical company's website.¹⁶² The endorsement is advertising.¹⁶³ If the fair market value of the advertising exceeds two percent of the total funding provided by the pharmaceutical company to the exempt organization, then only the portion of the payment, if any, that the exempt organization can demonstrate exceeds the fair market value of the advertising is a sponsorship payment excluded from unrelated business income taxable to the exempt organization.¹⁶⁴

It remains to be seen whether IRS agents will surf the internet to determine whether statements and links on exempt organizations' web sites, and sites of business sponsors of exempt organizations, constitute qualified sponsorship or unrelated business income taxable to the exempt organization. An exempt organization should carefully review its current sponsorship agreements and craft any new ones to be sure they do not confer substantial return benefit to the sponsoring business and that they merely "acknowledge" the sponsor rather than "advertise" for the

158. *Id.*

159. Treas. Reg. § 1.513-4(f).

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.*

sponsor under the definitions set forth in the 2002 final Treasury Regulations.

B. Joint Ventures: Partnerships or LLCs Formed Jointly by Exempt Organizations with a For-Profit Partner(s)

In the case of a joint venture between an exempt organization and a for-profit partner, the exempt organization and the for-profit partner each contribute something to the joint venture and expect to receive something in return. Before engaging in a joint venture with a for-profit partner, the exempt organization should first address the risk that participating in the venture poses to maintaining the organization's tax-exempt status. The exempt organization should next consider the potential of unrelated business income tax to the exempt organization (which, if too great, may also place the exempt organization's tax-exempt status at risk).

1. Maintaining Tax-Exempt Status

To qualify for exemption from federal income tax as a charitable organization, an organization must be both organized and operated exclusively for charitable purposes.¹⁶⁵ The most significant question at issue in the context of joint ventures is whether the exempt organization can satisfy the operational test in light of its participation in the joint venture. An organization is operated exclusively for charitable purposes only if it engages primarily in activities that further its exempt purposes, and only if no more than an insubstantial part of its activities do not further such purposes.¹⁶⁶ The "Exempt Organization Handbook" used by IRS examiners states that the regulations' terms "exclusively," "primarily," and "insubstantial" present difficult conceptual problems, which can more readily be resolved on the basis of the facts of a particular case.¹⁶⁷

An organization is not operated exclusively for exempt purposes "unless it serves a public rather than a private interest."¹⁶⁸

165. I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(a)(1) (as amended in 1990).

166. Treas. Reg. § 1.501(c)(3)-1(c)(1).

167. Internal Revenue Service, *Exempt Organizations Technical Handbook*, in EO TAXJ. 7.8.2.3.4.1 (Paul Streckfus ed.) (Feb. 23, 1999).

168. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

The fact that some level of private benefit is conferred on a for-profit entity as a result of a joint venture between an exempt organization and the for-profit partner will not per se preclude the exempt organization from maintaining its exempt status.¹⁶⁹ An exempt organization may form and participate in a joint venture and maintain its tax-exempt status if participation in the joint venture (a) furthers an exempt purpose, (b) permits the exempt organization to act exclusively in furtherance of its exempt purpose, and (c) results only in incidental private benefit.¹⁷⁰ Because this three-part test was explained and used in Treasury Ruling 98-15,¹⁷¹ this article will refer to it as the “98-15 test.” Analysis of each of the three requirements of the 98-15 test will depend, in large part, upon whether the venture is a whole-organization venture, involving all of the assets of the exempt organization, or an ancillary joint venture, involving an insubstantial portion of the exempt organization’s assets, or something in between.

a. Exempt Purpose

Under the first part of the 98-15 test, the organization’s participation in the joint venture must further an exempt purpose.¹⁷² The first indicator of whether an exempt organization’s participation in a joint venture furthers an exempt purpose is whether the document creating the venture (the partnership agreement for a partnership, or the operating agreement for an LLC) makes the exempt purpose primary to other purposes.¹⁷³

Treasury Ruling 98-15 explains a whole-organization joint venture that would meet the operational test, and one that would not.¹⁷⁴ In the joint venture that met with the IRS’s approval, the venture’s governing documents provided that the venture would operate any hospital it owned in a manner that furthered exempt purposes by promoting health for a broad cross section of its community.¹⁷⁵ The governing documents in Treasury Ruling 98-15

169. See *Plumstead Theatre Soc’y, Inc. v. Comm’r*, 74 T.C. 1324, 1333–34 (1981).

170. *Redlands Surgical Servs. v. Comm’r*, 113 T.C. 47, 70–71 (1999), *aff’d per curiam*, 242 F.3d 904 (9th Cir. 2001); Rev. Rul. 98-15, 1998-1 C.B. 718.

171. Rev. Rul. 98-15, 1998-1 C.B. 718.

172. *Redlands Surgical*, 113 T.C. at 92; Rev. Rul. 98-15, 1998-1 C.B. 718.

173. See Rev. Rul. 98-15, 1998-1 C.B. 718.

174. *Id.*

175. *Id.* The discussion of the community benefit standard in the Treasury

also explicitly provided that the exempt purposes furthered by the venture must override any duty to operate for the financial benefit of the partners to the venture.¹⁷⁶ The governing documents for the joint venture that did not meet with the IRS's approval in Treasury Ruling 98-15 simply stated that the venture's purpose was to "construct, develop, own, manage, operate and take other action in connection with operating the health care facilities it owns and engage in other health care-related activities."¹⁷⁷

In determining whether the venture furthers an exempt purpose, the tax court has also placed importance on the language of the governing documents of a joint venture. In *Redlands Surgical Services*,¹⁷⁸ an exempt organization created a subsidiary with the sole purpose to engage in a joint venture with a for-profit health care system to operate a surgery center. The prefatory "Whereas" clauses to the governing document for the venture provided that the partners entered into the agreement to "insure the availability of high quality health services in the most cost effective setting in which such services can be rendered," and to further the exempt organization's purpose of "providing comprehensive health care services at an affordable price."¹⁷⁹ The court was not impressed with this language in the "Whereas clauses," especially in light of the fact that the governing documents allowed the venture to "engage in any and all other activities as may be necessary, incidental or convenient to carry out the business of the Partnership."¹⁸⁰ In the end, the tax court considered the lack of exempt purposes in the governing documents, along with other factors, to decide that the venture did not further an exempt purpose, and that the organization seeking to obtain exempt status

ruling was necessary because the provision of health care, in and of itself, is not sufficient to qualify an organization for tax-exempt status. Rev. Rul. 69-545, 1969-2 C.B. 117. Health care organizations must satisfy the specific community benefit standard to be considered charitable. Rev. Rul. 98-15, 1998-1 C.B. 718; *see, e.g.*, *Harding Hosp., Inc. v. United States*, 505 F.2d 1068, 1072-74 (6th Cir. 1974). An organization that engaged in a non-health care related exempt endeavor would not have to prove community benefit, in this particular meaning, but would have to demonstrate that the activities of the venture furthered the exempt purposes of the organization. *See generally* Gerald M. Griffith, *Post-Tax Day Bonus for Ancillary Joint Ventures: Treasury Ruling 2004-51*, 2 HEALTH LAW. WKLY. 21 (May 21, 2004).

176. Rev. Rul. 98-15, 1998-1 C.B. 718.

177. *Id.*

178. 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001).

179. *Id.* at 79 n.11.

180. *Id.*

in the venture did not deserve exempt status.¹⁸¹

In the case of an ancillary joint venture, where the venture is an insubstantial part of the exempt organization's activities, it appears to be sufficient for the governing documents to limit the scope of the venture's activities and require that the venture not engage in any activities that would jeopardize the organization's exemption.¹⁸² In a very recent ancillary joint venture Treasury ruling, an exempt university formed a venture with a for-profit company that specialized in conducting interactive video training programs to offer teacher training seminars in off-campus locations using the interactive video technology.¹⁸³ The governing documents limited the venture's activities to conducting the teacher training seminars and also required that the venture not engage in any activities that would jeopardize the university's exemption under § 501(c)(3). Although the ruling does not state it explicitly, the venture served the dual purposes of educating teachers and producing income (for both the university and the for-profit partner). The IRS concluded that this venture did not affect the university's exemption despite the lack of any statement in the governing documents that the venture furthered an exempt purpose or that the exempt purpose overrode any other purpose of the venture.¹⁸⁴

In 2004, the IRS's Continuing Professional Education (CPE) series included an article entitled "Health Care Provider Reference Guide" to assist with the processing of exemption applications filed by health care providers.¹⁸⁵ While this 2004 CPE text was issued for the particular benefit of agents assessing health care providers, its analysis demonstrates the IRS's position relative to many issues regarding joint ventures between exempt and nonexempt organizations. The 2004 CPE text includes a 21-question checklist to be used by IRS agents as they process exemption applications.¹⁸⁶ If the organization applying for exempt status participates in a joint venture, partnership, or LLC arrangement with a for-profit entity, the 2004 CPE text directs the agent to determine whether the

181. *Id.* at 92-93.

182. Rev. Rul. 2004-51, 2004-22 I.R.B. 974.

183. *Id.*

184. *Id.*

185. Janet E. Gitterman & Marvin Friedlander, *Health Care Provider Reference Guide*, in EXEMPT ORGANIZATIONS TECHNICAL INSTRUCTION PROGRAM FOR FY 2004, (forthcoming 2004) (on file with authors) [hereinafter "2004 CPE text"].

186. 2004 CPE text, *supra* note 185 (manuscript at 26-29).

governing documents: (1) require the venture to operate all of its health care entities (including any assets contributed by the for-profit partner) in a manner furthering charitable purposes;¹⁸⁷ (2) explicitly provide that directors of the venture have a duty to operate in a manner furthering charitable purposes and that this may override their duty to operate for the financial benefit of the for-profit partners; and (3) are legal, binding and enforceable under state law.¹⁸⁸

The following suggestions regarding the exempt purpose of a joint venture apply equally to whole and ancillary joint ventures, even though in a truly ancillary joint venture (where the venture represents an insubstantial part of the exempt organization's activity), the organization's exempt status should not be at issue at all.¹⁸⁹

- **Governing Documents**

Just as the purposes clause for the articles of incorporation of a nonprofit corporation and the corresponding form 1023 (application for exemption to the IRS) must be carefully crafted, the purposes clause in the governing documents of a joint venture must be carefully drafted to ensure that the exempt purposes are obvious, sufficiently described, primary to other purposes, and enforceable by the exempt organization.

If the purpose clause sounds similar to the articles of a for-profit corporation, allowing the venture to engage in all lawful activity, the venture may be at risk of not passing the exempt purpose test.

The governing documents should explicitly provide that directors have a duty to operate the venture in a manner furthering exempt purposes.

A provision requiring the venture to place exempt activities

187. *Id.* (manuscript at 28).

188. *Id.*

189. *See, e.g.* Rev. Rul. 2004-51, 2004-22 I.R.B. 974; David M. Flynn, *CA-5 Remands St. David's But Provides Little Clarification On "Control" in Joint Ventures*, 100 J. TAX'N 40, 54 (2004).

over profit motivations is probably not required in every case, but would certainly be evidence of strong exempt purpose.

- **Governing Documents, Ancillary Joint Venture**

If the venture is an ancillary joint venture that obviously comprises an insubstantial part of the exempt organization's activities, it appears that the governing documents of the venture need only limit the venture's activities (to those specifically contemplated by the venture) and state that the venture shall not engage in any activities that might jeopardize the exemption of the exempt partner.

b. Exempt Organization Control

To meet the second part of the 98-15 test, the exempt organization participating in a joint venture with a for-profit partner must demonstrate that participation in the venture permits the exempt organization to act exclusively in furtherance of its exempt purpose.¹⁹⁰ In an important Fifth Circuit case examining joint ventures between exempt organizations and for-profit partners, an exempt organization argued that this issue should be determined by looking at the level of charitable works accomplished by the venture.¹⁹¹ The Fifth Circuit disagreed, holding that whether participation in a joint venture allows an exempt organization to act exclusively in furtherance of its exempt purposes can be determined by an examination of the structure and management of the venture to determine who controls the venture.¹⁹² If the for-profit partner has formal or effective control of the venture, the courts assume that the venture furthers the profit-seeking motivation of the for-profit partner.¹⁹³ On the other hand, if the exempt organization entering into a venture with a for-profit partner keeps control of the venture, courts presume that

190. See Rev. Rul. 98-15, 1998-1 C.B. 718.

191. *St. David's Health Care Sys. v. United States*, 349 F.3d 232, 235 (5th Cir. 2003).

192. *Id.* at 237. See also *Redlands Surgical Servs. v. Comm'r*, 113 T.C. 47, 78 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001).

193. *St. David's*, 349 F.3d at 237.

the exempt organization's activities through the venture primarily further exempt purposes, allowing the exempt organization to satisfy the second prong of the 98-15 test.¹⁹⁴ The question is how to measure control of a joint venture, and how much control the exempt organization must keep over a venture with a for-profit partner to satisfy the IRS. The test considers all the facts and circumstances surrounding the joint venture; a handful of IRS Treasury rulings and federal court cases are helpful.

In the "good" venture example of Treasury Ruling 98-15, the exempt organization appointed a majority of the board members governing the venture.¹⁹⁵ The governing documents could only be amended with approval of both the exempt and for-profit partners, and a majority of the board was required to approve major decisions relating to the venture's operation, including budgets, distributions, selection of key employees, purchase or sale of facilities, large contracts, changes to the types of services offered by the venture, and renewal or termination of management contracts.¹⁹⁶ The venture entered into a management agreement (which the IRS called "reasonable") with a company unrelated to either the exempt or for-profit organization to provide day-to-day management of the venture.¹⁹⁷ The agreement was for a five-year period, renewable by mutual consent.¹⁹⁸ The management company was to be paid a fee based on the venture's gross revenues.¹⁹⁹ Under these circumstances, the IRS determined that the exempt organization maintained control of the venture, satisfying the second part of the 98-15 test.²⁰⁰

In contrast, in the "bad" example of a joint venture in Treasury Ruling 98-15, the IRS concluded that the exempt organization had ceded too much control to its for-profit partner.²⁰¹ The exempt organization and the for-profit partner had equal control of the board governing the "bad" venture.²⁰² The governing documents did not require majority board approval for purchase or sale of facilities, usual contracts, changes to the types of services offered by

194. *Id.* at 238.

195. Rev. Rul. 98-15, 1998-1 C.B. 718.

196. *Id.*

197. *Id.*

198. *Id.*

199. *Id.*

200. *Id.*

201. *Id.*

202. *Id.*

the venture, or renewal or termination of management contracts.²⁰³ Further, in the “bad” example, the venture entered into a management contract with a wholly-owned subsidiary of the for-profit partner which the venture could only terminate for cause.²⁰⁴ The exempt organization agreed to approve the selection of two persons previously employed by the for-profit partner as the CEO and CFO of the venture.²⁰⁵

Maintaining majority control in the exempt organization over decisions regarding changes in activities, disposition of assets and renewal of the management agreement was necessary to the IRS in Treasury Ruling 98-15.²⁰⁶ Further, the IRS was concerned that in the “bad” example, where control was shared equally, the exempt organization would not be able to initiate exempt programs to serve new needs within the community without the agreement of at least one board member appointed by the for-profit partner.²⁰⁷ The pre-existing relationships between the chief executives of the for-profit partner and the management company concerned the IRS because those individuals would control the flow of information to the board.²⁰⁸ The IRS also noted concern that the management company could approve all but unusually large contracts and could unilaterally renew its management agreement without board approval.²⁰⁹

In *Redlands*, the exempt organization and the for-profit partner shared board control equally.²¹⁰ As a result, the exempt partner could veto actions proposed by the for-profit partner, but it could not initiate action without the consent of at least one of the board members appointed by the for-profit partner.²¹¹ The exempt partner could not unilaterally change operations of the venture to better serve its charitable constituency or to terminate the management agreement between the venture and a subsidiary of the for-profit partner.²¹²

Having determined that the control structure did not allow the

203. *Id.*

204. *Id.*

205. *Id.*

206. *Id.*

207. *Id.*

208. *Id.*

209. *Id.*

210. *Redlands Surgical Servs. v. Comm’r*, 113 T.C. 47, 79 (1999).

211. *Id.*

212. *Id.* at 79–80.

exempt organization to effectuate its purposes, the tax court in *Redlands* next considered whether mitigating circumstances existed that might make up for the exempt organization's lack of control.²¹³ Mitigating factors considered by the court included the existence of an arbitration process whereby a neutral third party finally decided issues over which the board was deadlocked,²¹⁴ whether the composition of other committees with oversight of important matters provided informal control to the exempt organization,²¹⁵ and whether the exempt organization had any other influence or ability to command allegiance or loyalty of the for-profit partner and its affiliates.²¹⁶ Finding that none of these factors mitigated the lack of formal control, and noting a very restricting non-compete agreement that would prevent the exempt organization from offering charitable services of the type provided by the venture for many years, the court held that the exempt organization had ceded control and could not satisfy the second part of the 98-15 test.²¹⁷

In discussing the issue of control, the Fifth Circuit in *St. David's* first looked to the motivation behind the venture and found that St. David's had entered into the venture out of financial necessity (to obtain the revenues needed to "stay afloat").²¹⁸ In contrast, Columbia/HCA Healthcare Corporation (HCA) (the for-profit partner) was motivated to enter the venture by its desire to gain entry to a new market.²¹⁹ The court felt that this financial disparity was so great that St. David's must have been forced to acquiesce significantly to HCA in the formation of the venture's power structure.²²⁰ In *St. David's*, control of the board of the venture was split evenly.²²¹ Accordingly, St. David's had veto power, but could not initiate action to further its exempt purposes without majority control of the board.²²² The court found this to be true despite the fact that St. David's appointed the board chair because although the board chair presided over meetings of the board and set the

213. *Id.* at 80–81.

214. *Id.* at 81.

215. *Id.* at 84.

216. *Id.* at 85.

217. *Id.* at 88–89, 92.

218. *St. David's Health Care Sys. v. United States*, 349 F.3d 232, 239 (5th Cir. 2003).

219. *Id.*

220. *Id.*

221. *Id.* at 241.

222. *Id.* at 241–42.

agenda for meetings, the board chair could not make decisions or initiate action without the consent of the rest of the board.²²³

The court found further evidence that St. David's had ceded control to HCA in the management agreement with a subsidiary of HCA.²²⁴ In St. David's favor, the agreement provided that St. David's could unilaterally terminate the management company if the management company took any action that could adversely affect St. David's exempt status.²²⁵ It also required the management company to abide by the community benefit standard.²²⁶ The court was not impressed with these safeguards in light of four facts. First, because the management company was affiliated with the HCA, the court believed that it would be more likely to prioritize the interests of that partner over the exempt interests of St. David's.²²⁷ Second, the management company's fee was calculated as a percentage of the venture's net revenue, which the court believed would further fuel its profit-seeking motive.²²⁸ Third, the term of the contract with the management company was fifty-four years.²²⁹ Fourth, the primary means for St. David's to enforce the management agreement was to sue the management company.²³⁰ The court expressed skepticism that St. David's would incur the expense and hardship of instituting a legal action every time the management company failed to comply with the amorphous community benefit standard.²³¹

Although St. David's had the power to appoint the first CEO and unilaterally remove any CEO of the venture, the court did not give these powers much credence.²³² One of the CEO's responsibilities was to generate annual charity care reports for the venture.²³³ The CEO failed to generate the reports in 1996 and 1997, and the court thought it was significant that St. David's took no action against the CEO for this failure.²³⁴ The court also gave no

223. *Id.* at 242 n.12.

224. *Id.* at 241.

225. *Id.*

226. *Id.* at 242 n.13.

227. *Id.* at 241–42.

228. *Id.* at 242 n.13.

229. *Id.* Signed in 1996, the agreement ran until 2050, as long as HCA continued to be a partner to the venture.

230. *Id.* at 243.

231. *Id.*

232. *Id.*

233. *Id.*

234. *Id.*

weight to St. David's power to unilaterally dissolve the venture if a change in the law could mean that participating in the venture would jeopardize its exempt status.²³⁵ The court said that HCA would never take the threat of dissolution by St. David's seriously because the governing documents contained a non-compete clause that would have prevented St. David's from operating in the region for two years after dissolution.²³⁶

With regard to the issue of control, the IRS directs its examiners to ask the following questions:

1. Is a majority of the governing board chosen by the exempt organization?
2. Does a majority of the governing body approve major decisions that include: the capital and operating budgets, distribution of earnings, selection of key executives, purchase and sale of facilities, large contracts, changes to the types of services offered, and renew or termination of any management contract?
3. Are any management contracts for a definite term of years and terminable for cause?²³⁷

This list of questions demonstrates that in 2004, the IRS continues to view majority board control as the first question in evaluating a joint venture. Because it is neither the last nor the only question agents are directed to answer regarding control of a joint venture, majority board control must not be an absolute requirement.

At best, the Fifth Circuit's opinion in *St. David's* makes life complicated for exempt organizations looking to venture with for-profit partners. On remand, the jury found that St. David's should maintain its tax-exempt status.²³⁸ The district court's final judgment provides no analysis of the legal issues surrounding control of a joint venture, meaning that for practitioners considering other joint ventures, the principles set forth in the

235. *Id.* at 244.

236. *Id.*

237. 2004 CPE text, *supra* note 185.

238. *St. David's Health Care Sys., Inc. v. United States*, No. CIV.A01CV046JN, 2004 WL 555095, at *1 (W.D. Tex. Mar. 18, 2004).

Fifth Circuit's decision in *St. David's* stand.

If having a 50/50 board will not doom every joint venture—St. David's after all, kept its exempt status—ventures with a 50/50 board must have other strong protections in the governing documents that allow the exempt organization to propose and implement initiatives in furtherance of the purposes of the exempt organization and make those initiatives paramount to considerations concerning profitability. That said, every protection afforded St. David's in this regard was summarily disregarded, and normal corporate governance structures (including the fact that the board chair could not take action without support of the majority of the board) were highlighted as evidence that the exempt organization ceded control to the for-profit partner.²³⁹ Seemingly well-intentioned and practical protections in the control structure were found to be undercut by the economic realities of the relationship between the exempt organization and the for-profit partner.²⁴⁰

In the wake of Treasury Ruling 98-15, *Redlands* and *St. David's*, exempt organizations grapple with how to structure the control of a joint venture so that it is both palatable to a potential for-profit partner and sufficient legally to meet the second prong of the 98-15 test.²⁴¹ The following suggestions regarding control of a joint venture apply equally to whole and ancillary joint ventures, even though, as previously mentioned, in a truly ancillary joint venture, the organization's exempt status should not be at issue at all.

- **Contemporaneously Document Need for Services To Be Provided by Venture**

When the venture is being contemplated, the exempt organization should document the need in its constituency for the services to be provided by the venture. So, for example, if the exempt organization is a theatre, and it enters into a joint venture with a for-profit partner to produce several theatre productions in an underserved region in its state, the exempt organization should

239. *St. David's Health Care Sys. v. United States*, 349 F.3d 232, 242 n.12 (5th Cir. 2003).

240. *Id.* at 242.

241. See generally Fred Stokeld, *EO Community Ponders Meaning of St. David's Holding*, 43 EXEMPT ORG. TAX REV. 23 (Jan. 2004).

document the lack of theatre productions in the underserved region and should explain the manner in which the venture will help to fill that need.

The exempt organization should record these findings of need in its board minutes or in an official board report.

This documentation should help protect an exempt organization from subsequent findings of a court or of the IRS that the organization entered into a joint venture out of desperation or economic necessity, if that is not the case. It also helps to establish the relatedness of the venture to the exempt organization's objectives.

- **Board Control**

Give the exempt organization the ability to appoint a majority of the directors of the governing body of a joint venture. It should be noted, however, that having control of a majority of the board will not protect an exempt organization involved in a joint venture if, despite the formal control structure, the for-profit partner, through contracts or other governing documents, in reality controls the venture.²⁴²

Anything short of 50/50 control will not suffice. Treasury Ruling 98-15—as well as *Redlands* and *St. David's*—suggests that the exempt organization must at the very least have veto/ blocking rights. As of 2002, the IRS had recognized exemption in very few cases where the tax-exempt entity's share of the control was as low as fifty percent, and none where control was lower.²⁴³

If control (or appointment rights) of the governing board is split equally between the exempt organization and the for-profit partner, the governing documents must require

242. See, e.g., *Hawaii v. Comm'r*, 71 T.C. 1067, 1080, 82 (1979); *aff'd* 647 F.2d 170 (9th Cir. 1981).

243. Lawrence M. Brauer et. al., *Update on Health Care, in* EXEMPT ORGANIZATIONS: TECHNICAL INSTRUCTION PROGRAM FOR FY 2002 161 (2002), *available at* 2002 WL 32593929, at *6.

the venture to act in a manner consistent with the exempt organization's tax-exempt status.

In the case of a 50/50 board, *St. David's* suggests that the exempt organization must maintain "effective" control over key, if not all, major decisions affecting the venture's ability to pursue its exempt mission, including, as appropriate, the sale and purchase of facilities or other capital investments necessary for the advancement of the exempt mission, and the expansion or redirection of exempt programs.

In the case of a 50/50 board, the exempt organization must also have some control over day-to-day decisions within the venture that would affect the accomplishment of exempt objectives, either through appointment of the CEO or by some other means of challenging management decisions that affect the accomplishment of exempt objectives.

To prove "effective" control of the venture, the exempt organization must not only demonstrate that it has contractually retained effective control, but also that it is willing to exercise effective control in the context of its relationship with its for-profit partner.

If the exempt organization has the right to require something of the for-profit partner or management company relating to the provision of exempt services, the steps taken to enforce that right should be documented by the board of the venture. If the exempt organization chooses not to enforce its rights relating to the provision of exempt services, the exempt organization should document why the right was not enforced. This should help prevent a court reviewing the facts at some time in the future from drawing a negative inference from the fact that the exempt organization failed to enforce its rights against the for-profit partner or management company.

- **Right To Sue Probably Not Sufficient**

It is probably not sufficient to require the exempt organization to resort to filing a lawsuit to ensure that the venture (through the CEO or the management company) is complying with its exempt purposes. Some less onerous means of enforcing the exempt purposes of the venture, such as committee review with authority to require action, must be provided for in the venture's governing documents.

- **Management Contracts**

If at all possible, management agreements should not be made between the joint venture and a subsidiary or affiliate of the for-profit partner. In all cases, the management agreements should require the managing company to act in furtherance of the exempt mission of the exempt organization, and should provide a reasonable means for the exempt organization to enforce such requirement.

The fee of the management company should not be calculated solely as a percentage of revenue. The calculation should include some formula for rewarding the management company for the provision of exempt services that may or may not produce revenue.

The term of the management agreement should be reasonable, i.e., it should be no more than a five-year term with the option to renew the agreement in additional five-year increments. The management company must not be able to unilaterally renew the management agreement. The exempt organization should have the opportunity to review the terms of the agreement periodically (every five years) to determine whether the agreement provides fair value to the venture.

- **Appointment of Key Staff**

The exempt organization should be allowed to unilaterally appoint and terminate the CEO of the joint venture.

Key staff, including the CEO and CFO should not have any prior relationship with the for-profit partner or its subsidiaries or affiliates.

The exempt organization must document the ways in which the CEO is responsible for the furtherance of the exempt aspects of the venture's operations. The governing documents should provide for a reasonable method of corrective action that will be taken in the event that the venture fails to further the exempt purposes. The exempt organization, through its board appointees, should regularly document the CEO's compliance with this responsibility or the corrective action taken to remedy the lack of compliance.

- **Document Exempt Accomplishments**

Even though the courts have held that the control structure, and not the exempt accomplishments of joint ventures, determines whether the exempt organization has acted exclusively in furtherance of its exempt purpose, the exempt organization should still record and promote its accomplishments. The fact that a venture never "held itself out as exempt" could, at least in part, form the basis for finding that the exempt organization had no control over the venture.

- **Termination Provision, Non-Compete Clause**

The exempt organization should be allowed to unilaterally dissolve the venture if it has reason to believe the venture could jeopardize its tax-exempt status. This right could be limited to circumstances when the exempt organization's legal counsel opines that the venture could jeopardize the exempt organization's tax-exempt status, but should not be restricted so as to apply only when there is a change in the law that might affect the exempt organization's exempt status.

The exempt organization should not accept a non-

compete clause which would prohibit it from offering the exempt services it provided before or during the operation of the joint venture.

c. Incidental Private Benefit

To meet the third part of the 98-15 test, the exempt organization participating in a joint venture with a for-profit partner must demonstrate that participation in the venture does not result in more than incidental private benefit.²⁴⁴ Analyzing private benefit generally requires the examination of the totality of the exempt organization's operations. "When an organization operates for the benefit of private interests . . . the organization does not, by definition, operate exclusively for exempt purposes."²⁴⁵ Prohibited private benefit would include any "advantage, profit, fruit, privilege, gain [or] interest" extended to recipients other than the intended beneficiaries of the exempt organization.²⁴⁶ When an occasional benefit flows to a private individual as the incidental consequence of an exempt organization's provision of services to its exempt constituency, this occasional benefit will not generally constitute prohibited private benefit.²⁴⁷ When an exempt organization's operations take on a commercial tone, the question of private benefit is a question of fact to be resolved on the basis of all the evidence presented. Relevant factors include the particular manner in which an organization's activities are conducted, the extent to which the exempt organization would compete with other commercial ventures, and the existence and amount of annual or accumulated profits as evidence of a forbidden private purpose.²⁴⁸

The prohibition against private *benefit* is not to be confused with the prohibition against private *inurement* of organizational earnings. Private inurement may result from a single act of an exempt organization. The concept of private inurement generally refers to benefits conferred upon insiders, such as officers, directors or creators, through the use or distribution of the organization's funds.²⁴⁹ Private inurement is narrower than the

244. Rev. Rul. 98-15, 1998-1 C.B. 718.

245. *Am. Campaign Acad. v. Comm'r*, 92 T.C. 1053, 1065 (1989).

246. *Id.* at 1065-66 (citation omitted).

247. *Id.* at 1066; *accord* *Redlands Surg. Servs. v. Comm'r*, 113 T.C. 47, 74 (1999).

248. *B.S.W. Group, Inc. v. Comm'r*, 70 T.C. 352, 358 (1978).

249. I.R.C. § 501(c)(3); Treas. Reg. § 1.501(a)-1(c), § 1.501(c)(3)-1(c)(2) (as

concept of private benefit in that an organization may generally further a public purpose but not qualify for tax-exempt status because of private inurement conferred upon insiders.²⁵⁰ Even a small amount of private inurement can result in excise taxes under § 4958 of the I.R.C., and jeopardizes the exempt status of an organization.²⁵¹ Unique opportunities for private inurement are plentiful in the context of joint ventures between exempt organizations and for-profit partners, because the IRS will look to the reality of the situation rather than the formal labels on each person's role within the venture.²⁵² An exempt organization should take care to identify all potential "insiders" from among the various players in a joint venture and evaluate all of their compensation from the venture in light of the prohibition on private *inurement*.

The mere fact that an exempt organization partners with a for-profit entity to form a venture whereby both partners expect to benefit does not, without more, constitute private *benefit*.²⁵³ Whether a joint venture between an exempt organization and a for-profit partner results in private benefit largely turns on whether the method of compensating the for-profit partner is fair and reasonable to the exempt organization. In *Harding Hospital*, the Sixth Circuit found that a partnership between an exempt organization and a group of doctors resulted in improper private benefit, in part because the exempt organization offered the doctors reduced rent and what the court evidently considered to be an overpriced supervision fee, as well as the "monopolistic" right to practice medicine at the exempt organization's facilities.²⁵⁴ In *Plumstead Theatre*, the tax court considered a joint venture between an exempt organization and an investor-type for-profit partner.²⁵⁵ The court said that such relationships are permissible so long as the arrangements between the exempt organization and the for-profit partner are at arms-length, the exempt organization is not obligated to reimburse the for-profit investor out of its own funds if the venture is unsuccessful, the exempt organization is in charge of

amended in 1990); *United Cancer Council, Inc. v. Comm'r*, 165 F.3d 1173, 1176 (7th Cir. 1999).

250. *Am. Campaign Acad.*, 92 T.C. at 1068-69.

251. *See* I.R.C. § 4958(c)(1)(A); Treas. Reg. § 53.4958-4(a)(1) (2002).

252. *See United Cancer Council*, 165 F.3d at 1176.

253. *See, e.g., Plumstead Theatre Soc'y, Inc. v. Comm'r*, 74 T.C. 1324, 1333-34 (1980).

254. *Harding Hosp., Inc. v. United States*, 505 F.2d 1068, 1078 (6th Cir. 1974).

255. *Plumstead Theatre*, 74 T.C. at 1325.

its exempt purpose work, and the for-profit partner's involvement with the exempt organization is limited to an insubstantial part of the exempt organization's activities.²⁵⁶

In *Redlands*, the tax court identified the market advantages and competitive benefits secured by the for-profit partner through the venture as examples of impermissible non-incidental private benefit.²⁵⁷ The tax court plainly stated that the for-profit partner acquired its interest in the venture at a "bargain price," stating that there had been a higher bid by an unrelated for-profit entity.²⁵⁸ In addition to the bargain price, the tax court detailed the very sophisticated manner in which the for-profit partner in *Redlands* structured the venture to restrict competition for customers of the venture, to eliminate competitive constraints for setting fees (a matter the court noted was delegated to the for-profit subsidiary management company), to reduce competition for acquiring expensive equipment needed to operate the venture, and to gain the community respect accompanying the exempt organization's longstanding service to the community prior to entering into the venture. Because the tax court did not believe the terms of the venture were reasonable to the exempt organization, and because the control structure of the venture favored the for-profit partner, the tax court determined that the venture provided more than incidental private benefit.²⁵⁹

With regard to the issue of private benefit in joint venture situations, the IRS directs its examiners to ask the following questions:

1. Did the exempt organization receive ownership interest in the venture proportionate to its contribution?
2. Are all returns of capital and distributions of earnings made to the partners proportional to their ownership interests?
3. Are the terms, fees, and conditions of any management agreements reasonable and comparable to

256. *Id.* at 1333-34.

257. *Redlands Surgical Servs. v. Comm'r*, 113 T.C. 47, 92-93 (1999).

258. *Id.* at 91.

259. *Id.* at 92.

management contracts of other similarly situated organizations?

4. Were any officers, directors, or other employees of the exempt organization who were involved in the decision-making or negotiations involving the formation of the venture promised employment or any other inducement by the for-profit partner or any of its related entities or the venture itself?
5. Did any of the officers, directors, or other employees of the exempt organization who were involved in the decision-making or negotiations involving the formation of the venture have any interest directly or indirectly in the for-profit or any of its related entities?²⁶⁰

One could certainly argue that at least the last two questions relate to the issue of private inurement as well as to private benefit. Nevertheless, each of these questions addresses the reasonableness of the terms of the venture agreed to by the exempt organization and the for-profit partner.

It appears that the required equality of distributions and reasonableness of contracts serves to insure that the for-profit organization does not obtain any disproportionate financial benefit, which would raise private benefit concerns.²⁶¹ An article in the IRS's 2002 Continuing Professional Education series stresses the importance of a proper valuation of interests contributed to the venture by the exempt organization and the for-profit entity in avoiding a claim of improper private benefit.²⁶² The article recommends that if an exempt organization contributes assets other than cash to a venture, it should obtain a certified appraisal by an independent third-party appraiser to be sure it receives appropriate credit for the contribution.²⁶³ Further, in the event of a whole organization joint venture, the exempt organization should be credited for the value of any business it brings to the venture, including the value of the income generated by any facility

260. 2004 CPE text, *supra* note 185 (manuscript at 28).

261. See Griffith, *supra* note 175.

262. Brauer et al., *supra* note 243, at 161–62.

263. *Id.* at 162.

contributed by the exempt organization.²⁶⁴ The 2002 and 2004 CPE text, and relevant cases provide the basis for the following suggestions regarding the prevention of private benefit in the context of a joint venture.

1. Proper Interests

All partners to a joint venture must receive an interest in the venture equal in value (in proper proportion) to the assets they contributed to the venture.

Similarly, the exempt organization and the for-profit partner's returns from the venture must be proportional to their respective investments in the venture.

When the exempt organization commits some asset other than cash to the venture, the only way to insure that the exempt organization obtains an interest in the venture equal to the value of the assets it contributed is to have an independent certified appraisal of the assets contributed. The value of the assets contributed should be documented carefully in board minutes or other governing documents of the venture.

The exempt organization should be credited for the value of any business it brings to the venture, including the value of the income generated by any facility contributed by the exempt organization to the venture.

2. Highest Bidder

If there is a bidding process, and if the exempt organization decides to proceed with a joint venture with a for-profit partner that did not offer the highest cash bid to the exempt organization, the exempt organization should document the reason it chose a lower bidder and the extra intangible benefit (which should also be somehow quantified) brought to the venture by the chosen for-profit partner. This would help counter the later challenge that

264. *Id.*

the for-profit partner obtained the deal at a “bargain” price.

3. Contracts

All contracts and transactions entered into by the venture with the exempt organization, the for-profit organization, and any other party must be for fair market value determined by reference to the prices for comparable goods or services in the marketplace.

This requirement of reasonableness applies most importantly to any management contract entered into by the venture, and especially if the management contract involves an affiliate or subsidiary of the for-profit partner.

4. Insider Influence

The exempt organization should take particular care if any officers, directors, or other employees of the exempt organization who were involved in the decision-making or in negotiations involving the formation of the venture are promised employment by or have any other interest in the for-profit partner or any of its related entities or the venture itself.

5. Intangible Benefits

An exempt organization should identify and leverage any of the following potential benefits in its bargaining with the for-profit partner and be sure it receives some measurable (documented) return for the intangible benefit:

- restricting competition for the constituents of the venture, who used to be constituents of the exempt organization;
- eliminating competitive constraints for setting fees, which might adversely effect the ability of the constituents of the exempt organization to

obtain the services to be provided by the venture;

- reducing competition for acquiring expensive equipment or materials needed to operate the venture; or
- providing it with the community respect accompanying the exempt organization's longstanding service to the community prior to entering into the venture.

6. Obligation to Reimburse

The exempt organization should not be obligated to reimburse the investor-type for-profit partner out of its own funds if the venture is unsuccessful.

In summary, an exempt organization may form and participate in a joint venture without jeopardizing its exempt status if participation in the joint venture (a) furthers a charitable purpose, (b) permits the exempt organization to act exclusively in furtherance of its exempt purpose, and (c) results only in incidental private benefit.²⁶⁵ After considering the venture's potential impact upon its exempt status, the exempt organization must address the tax consequences resulting from its participation in the joint venture.

2. *Taxation of Joint Ventures*

Except for the technical manner in which the money flows into the exempt organization, the discussion of unrelated business income that occurs when an exempt organization participates in a joint venture with a for-profit partner is no different from the discussion of unrelated business income generated by an exempt organization within its existing corporate structure.²⁶⁶ Special rules

265. Rev. Rul. 98-15, 1998-1 C.B. 718; *Redlands Surgical Servs. v. Comm'r*, 113 T.C. 47, 92-93 (1999).

266. See, e.g., Rev. Rul. 2004-22 I.R.B. 964 (applying the same principles to the discussion of unrelated business income in the joint venture context as are applied traditionally in the analysis of unrelated business income within an exempt organization).

apply if the joint venture is in the form of an S corporation.²⁶⁷ An exempt organization involved in a joint venture should first determine whether income flowing from the venture is unrelated business income,²⁶⁸ and second whether any unrelated business income is substantial in light of all the other activities of the exempt organization.

If the exempt organization forms a partnership for the purpose of entering into a joint venture with a for-profit partner, the activities of the partnership are considered to be the activities of the partners for federal income tax purposes.²⁶⁹ In such a case, the exempt organization that is a member of a partnership regularly engaged in the conduct of an unrelated trade or business must include its share (distributed or undistributed) of the net income of the partnership in computing its net income. If the venture's activity is not substantially related to the exempt purposes of the exempt organization, it must include its share of the net income of the partnership in computing its unrelated business taxable income.²⁷⁰ The example in Treasury Ruling 98-15 uses an LLC (treated as a partnership for tax purposes) as the entity through which the joint venture is conducted. There is no factual significance in the fact that an LLC is the joint venture arrangement rather than a limited partnership or general partnership.²⁷¹ The IRS used the LLC because it wanted to bring into focus what was then a relatively unknown kind of organizational structure, and to clarify that using an LLC changes nothing with regard to the tax treatment of a joint venture so long as the LLC is deemed a partnership for tax purposes.²⁷² In filing its IRS Form 990, the exempt organization should pay particular attention to question 88 of Part VI and Part III of Schedule A as those questions require disclosure and explanation of relationships

267. See I.R.C. § 512(e).

268. For the present, Treasury Ruling 2004-51 is something of a safe harbor whereby practitioners can give a fair amount of comfort to their clients that if the exempt organization maintains control of all the essential exempt characteristics of the ancillary joint venture's activities, unrelated business income should not derive from the venture.

269. See *Butler v. Comm'r*, 36 T.C. 1097 (1961).

270. Treas. Reg. § 1.512(c)-1 (2000).

271. Mary Jo Salins & Marvin Friedlander, *Update on Health Care Joint Venture Arrangements*, in EXEMPT ORGANIZATIONS: CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FY 2000 17 (2000), available at 2000 WL 34402216, at *4.

272. *Id.*

like those that would be expected to occur in joint ventures between an exempt organization and a for-profit partner.

IV. CONCLUSION

Real opportunities exist for exempt organizations to generate income through non-traditional, business-type activities. Joint ventures have become a prevalent means for an exempt organization to accomplish something through the dedication of assets by a for-profit partner that the exempt organization otherwise would not have been able to accomplish. That said, the public expects charities to behave charitably. Exempt organizations must exercise extreme caution in undertaking unrelated business activities, either directly through a taxable subsidiary or through a venture with a for-profit partner. Failure to exercise such caution may result in loss of the organization's most valued asset, its exempt status.